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C O N F I D E N T I A L SECTION 01 OF 03 TOKYO 005196

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TREASURY FOR IA/DOHNER, HAARSAGER, WINSHIP, POGGI

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SUBJECT: JAPAN: FROM GROWING THE PIE TO HANDING OUT PORK?

REF: TOKYO 5090

Classified By: Ambassador J. Thomas Schieffer for reasons 1.4 b and d

¶1. (C) Summary: Prime Minister Fukuda, though initially reiterating former Prime Minister Abe's fiscal goals of achieving a primary deficit surplus by FY 2011 and reducing the debt-to-GDP ratio by the mid 2010s, appears to have turned away from the Abe pro-growth strategy. Since the disastrous Upper House election in July, tensions have been building within the LDP among fiscal conservatives, who want to cut expenditures and raise taxes to put Japan on a fiscally sustainable path, the pro-growth camp, and a third group who want to return to pork-barrel public spending in order to build support with voters prior to the next election. Intra-LDP tussles on fiscal policy have been complicated by the DPJ's new role as the largest party in the Upper House and the influence that this accords them. The DPJ can affect tax reform directly through submitting their own tax bills in the Diet or failing to pass government-submitted tax bills, and can influence the disbursement of spending measures by blocking budget-related bills in the Upper House. End Summary.

Where does Fukuda stand?

¶2. (C) Immediately following his selection as Prime Minister, press reports speculated that Prime Minister Fukuda would carry on the fiscal reconstruction policies of former Prime Minister Abe. During the LDP presidential campaign, Fukuda told the press that &since the budget is limited, we must use our resourcefulness.8 Fukuda's appointment of several noted fiscal conservatives, namely Sadakazu Tanigaki as the LDP's Policy Affairs Research Council chairman and Kaoru Yosano as the LDP Tax Commission subcommittee chair confirmed this impression for many. However, these appointments also fuelled discussions about whether the Fukuda administration was abandoning the pro-growth rhetoric of the Abe government, which aimed to expand the economic pie through structural reform measures that would boost economic growth and raise tax revenues organically, while continuing to pursue expenditure cuts before tax increases.

¶3. (C) On October 17, the Council on Economic and Fiscal Policy, chaired by the Prime Minister, discussed Cabinet office projections, laying the groundwork for a consumption tax hike by showing a number of scenarios with varying growth and expenditure cut assumptions. Almost none of these, however, could achieve the GOJ's stated objective of reaching a primary budget surplus by FY2011 without a consumption tax hike. The low-growth projections led many observers to conclude a consumption tax hike is an inevitable policy choice. Some analysts further suggested the GOJ is

turning away from the pro-growth approach toward fiscal policy based on higher taxes, and may indicate an abandonment of further structural reform efforts.

¶4. (C) In practice, the pro-growth reforms outlined by the Abe administration did not come to fruition for the most part. The readmission to the party of the former LDP rebels who had opposed postal privatization, as well as the mishandling of the proposal to reorient the use of revenues from gasoline-related taxes currently dedicated to road construction and maintenance to the general fund, convinced many that Abe was not serious about continuing the Koizumi-era reforms.

But What about the Rest of the LDP?

¶4. (C) In contrast to the initial perceived stance of fiscal conservatism evinced by the Fukuda government, there are clearly voices within the LDP clamoring to increase spending to shore up support in traditional LDP strongholds for the next election. Indeed, Fukuda himself has sought to reassure reform-weary constituencies and has talked about the need to address regional and income disparities. How a balance will be struck remains to be seen. In an initial indication pointing to some increase in fiscal spending, the LDP and Komeito agreed in early September and PM Fukuda confirmed at the end of October that plans put into law in June 2006 to increase health care payments by the elderly would be postponed. Continuing to fund the same level of payments by the GOJ will cost the taxpayers an additional 150 billion yen in FY08.

Is the DPJ a Threat to the LDP,s Plans for Fiscal Policy?

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¶5. (C) As the largest party in the Upper House, the Democratic Party of Japan (DPJ) aims to achieve political gain by foiling the Liberal Democratic Party,s (LDP) attempts at legislative policymaking. Regarding fiscal policy, the DPJ is better placed to affect tax legislation, which requires the concurrence of the Upper House, than budget, which does not. Necessary implementing legislation for the budget, however, will need to be agreed by the Upper House or overridden by a two-thirds majority in the Lower House. In seeking a deal on tax reforms and the budget implementing legislation, the ruling LDP-Komeito coalition may have to make concessions to the DPJ on the budget side as well. Recent events, however, may weaken the opposition party's ability to utilize any of these parliamentary maneuvers

¶6. (C) During the Upper House election campaign, the DPJ promised to boost public spending by 15 trillion to deal with the disparities regarded as results of the LDP,s Koizumi-era reforms, including measures to create a new child allowance program, use all consumption tax revenues to support the basic pension program, support small and medium sized enterprises, eliminate highway tolls, provide income support to farmers, and eliminate public high school tuition. The DPJ has opposed raising the consumption tax and has suggested somewhat unrealistic plans to raise revenues to fund the additional proposed spending, such as realizing cost savings from eliminating bid-rigging and amakudari, abolishing special public corporations, reducing expenses for central government employees and reducing central government subsidies to local governments by adopting a lump sum program. In addition, the DPJ has said it will carefully examine the elimination of 43 temporary tax measures slated to expire.

¶7. (C) The DPJ could submit its own tax reform bills to the Diet. Such a move could lead to a conflict scenario where the Upper House approves DPJ tax bills, while the Lower House approves the tax bills submitted by the government. In that case, the ruling coalition parties may need to overrule the

Upper House decision with a two-thirds vote. Action on tax bills will need to be completed by end-March 2008 to provide financing for the regular FY08 budget, and due to the expiry of many temporary tax measures at that time. The strategy would be the same that has been expected to handle the restoration of Japan's participation in Operation Enduring Freedom in the Indian Ocean.

The Supplemental Budget is the Thing to Watch

18. (C) The result of the fiscal negotiations is not easy to predict at this point, even more so because of the changing dynamics in the DPJ resulting from Ozawa's resignation, but some likely aspects can be surmised from the process itself. The parameters of the FY08 regular budget were set when the Cabinet approved the budget guidelines in August. The MOF is now negotiating with the various ministries to whittle back the budget requests to within the Cabinet approved guidelines, and while there is wiggle room on the allocations of the spending within ministerial budget caps, there is no process for amending the overall regular budget guidelines.

19. (C) The FY07 supplemental budget, however, is a different story. Virtually every year, the GOJ compiles a housekeeping supplemental budget to fund all the items that have cropped up since the previous regular budget. Examples include reconstruction spending for natural disasters, overseas commitments for aid or development spending in response to unforeseen events, or necessary adjustments to allow increases in mandatory spending items, such as social security. During the post-bubble period, supplemental budgets were frequently used to fund public spending aimed at spurring economic growth. Whatever pork-barrel spending the LDP decides to propose will end up in the supplemental. The overall size of the FY07 supplemental will give a better indication of the Fukuda government's commitment to fiscal consolidation.

Whither the Consumption Tax

10. (C) Following his election, PM Fukuda reiterated his predecessor's plan for a discussion by the LDP of comprehensive tax reform, including corporate, income, consumption, and special tax measures. Sensitivities to concerns about disparities seem to have pushed consideration of changes to the corporate and income taxes from the agenda. The hot topic for the fall tax debate is the consumption

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tax. The GOJ has committed to find a stable funding source for the increase of the government contribution to the basic pension scheme in FY09 from a third to a half, a funding requirement of 2.5 trillion that is roughly equivalent to a 1 percent rise in the consumption tax. Prime Minister Fukuda stated during his campaign to be LDP President he would consider boosting the consumption tax. But there is a high degree of skepticism as to whether LDP can make a concrete recommendation this year to increase the consumption tax given the possibility of national elections in spring 2008. It usually takes three calendar years to implement a consumption tax hike) a formal decision is taken in the year-end tax deliberations (December), the change needs to be legislated in the following year's budget Diet session (spring of the following year), and implementation occurs at the start of the next fiscal year. So a decision made in this year's tax discussions to hike the consumption tax rate would be implemented just ahead of Lower House elections in September 2009, assuming an early election is not called.

11. (C) Election timing notwithstanding, the Cabinet office projections discussed at the CEFP on October 17 pointed to the difficulty of meeting GOJ fiscal goals without a consumption tax increase. Following that meeting PM Fukuda stated, &If we delay even further, our options will become even more limited. We need to quickly pursue discussions about these issues in a way that is easy to understand from

the public's perspective.⁸ As noted previously, the DPJ has already stated its opposition to raising the consumption tax.

¶12. (C) Besides a heated debate on the consumption tax, there are 43 tax measures that will expire by the fiscal yearend of March 2008 if no action is taken. In total, the net effect of the expiration of all 43 measures would be a loss of about 3 trillion in tax revenue, according to calculations by Deutsche Securities. The end of the temporary gasoline surcharge tax would have the largest single effect and cost the GOJ 1.4 trillion in tax revenues should it expire.

¶13. (C) LDP officials have indicated that they will recommend renewing the gasoline surcharge tax, whose revenues are used for road construction and maintenance. As noted above, Abe had argued use of the gasoline surcharge revenues should be reoriented from road maintenance and construction to general budget purposes. This proposal met with stiff resistance last fall from LDP members with rural constituents, who benefit disproportionately from road construction projects. Given the current concerns about regional disparities and lagging regional economies, a reorientation of the use of the revenues appears to be off the table.

¶14. (C) Comment: Developments on these issues will unfold over the next two months as the government compiles its budget and tax bills, and will come to a head early in the ordinary Diet session, which will begin in January 2008. The disarray in the major opposition party only adds to the confusion. At this point, the most likely outcomes are that the FY08 regular budget will be relatively restrictive following the budget guidelines approved by the Cabinet in August, with the FY07 supplemental budget being the real bellwether for the Fukuda Administration's fiscal policy direction. If there is pork-barrel spending to be had, here is where it will show up. The most contentious tax area is the consumption tax, which is likely to end up with an LDP acknowledgement that a consumption tax hike will be needed sometime in the future without specifying a concrete recommendation for timing or amount, thus pushing that decision into the future. End Comment.
SCHIEFFER